Discovery Flexible Property

Market background

The first quarter (Q1) of 2024 was marked by continued strength for risk assets, with a number of global equity indices extending their record highs. In the US, better-than-expected economic data raised hopes of a ‘soft landing’, with sentiment further supported by continued optimism towards AI-related stocks. In China, authorities introduced new measures to help stabilise equity flows after the market declined to a five-year low during the quarter. Meanwhile in South Africa, declines in the first two months of the year saw domestic equities close Q1 in negative territory, despite March being a much stronger month on the back of firmer gold and PGM prices.

On the fixed-income side, sharp upward moves in US Treasury yields weighed on global bond markets. While on the local front, higher inflation prints reduced support for local fixed income markets, with election uncertainty further weighing on the asset class.

Performance review

For the quarter, the Fund underperformed the benchmark.

The Fund’s continued underweight exposure to Fortress Real Estate was among the largest detractors from relative performance for Q1, after having been a positive contributor in the fourth quarter of 2023. The stock has been overshadowed by pending corporate action with multiple parties vying for specific interests. In our view, the base case outcome does not stack up fundamentally. However, many market players have voted in support of the relevant resolutions, citing 'deal fatigue' alongside a desire for Fortress Real Estate to reemerge as an investable option within the property universe. In March, following the close and execution of the corporate action, the Fund's underweight exposure to the stock was among the largest contributors to relative performance.

The Fund's global, off-benchmark counters contributed positively in March with expectations around earlier rate cuts in Europe fuelling performance relative to more US-centric counters. This trend, however, was more idiosyncratic for the quarter.

Outlook and strategy

The sharp increase in interest rates over 2022 and into 2023 resulted in a steep derating of the listed property sector, both locally and abroad. However, as the growing rhetoric regarding a pivot on rate decisions entered the fray in late 2023, interest-rate sensitive instruments re-rated, benefitting property stocks globally. Although there is much debate on whether markets have moved too much too soon, property yields remain decent while earnings growth troughs, after having been impacted by the steep rate increases of 2023.

As the interest rate cycle turns, the positive impacts on the property sector are compounded. Alongside rating support, the bottom line benefits from decreased finance costs. Typically, property companies on average hedge out c.90% of their interest rate exposure. In anticipation of rate changes, many companies have not renewed their hedging instruments. As such, the average for the sector sits below 80%, with the lowest at 55%. This provides a material upside opportunity for earnings and dividends in the sector as the cycle turns.

In our view, the improving fundamentals are supported by reasonable valuations, with total returns underpinned by income yield rather than re-rating potential within the year. The sector trades on a forward distributable income yield of c.11% and a c.35% discount to net asset value (NAV).

We believe the sector offers attractive value over a medium- to long-term time horizon, primarily supported by a more sustainable cash-covered yield, together with a constructive valuation that reflects near-term operational and balance sheet concerns.

In the current environment, we continue to assess the portfolio risks and actively screen for opportunities that market dynamics such as these are likely to offer. Ultimately, we aim to provide our clients with the best risk-adjusted medium- and long-term outcomes.

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